SOME CURRENT ECONOMIC PROBLEMS AND THE ECONOMIC AND FINANCIAL OUTLOOK

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by

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I am highly honored to address you here today. Alluding to the introduction, I should further tell you I have just come off the Federal Open Market Committee. This Committee is the most powerful policy-making group in the Federal Reserve System and consists of the seven-member Board of Governors appointed by the President of the United States and five of the twelve Federal Reserve Bank Presidents. The head of the New York Federal Reserve Bank is a regular member, while four Presidents serve on a rotating basis.

As the composition of this Committee changes, the press quite naturally likes to speculate on how this event might alter future Federal Reserve policy decisions. As I said at the outset, I have just served my term and am not due back as a voting participant until 1977. Taking note of that fact, one recent newspaper article speculated how the departure of the conservative Monroe Kimbrel would affect policy. Therefore, one of the most conservative is joining you today to share his thoughts on some current economic problems and the economic outlook.

While we all keep hearing more and more talk about an upturn in economic activity, I should note that the economy is still in recession. Just this last week the Commerce Department reported the real Gross National Product in the first quarter of 1975 declined at a 10.4-percent rate. That decline was more severe than the steep fall in the last three months of 1974 and marked the fifth consecutive quarterly decline in GNP. This news confirmed what we knew all too well. The current recession is the longest and deepest downturn since the 1930s. And surely you must be aware that the unemployment rate also exceeds anything experienced in other postwar recessions.

If this were all the news to report, I would not blame you for heading for a big glass of cider or perhaps something stronger. But, fortunately, there is good news and bad news. And the good news is that while the economy is still sliding down, the descent is beginning to look less steep. Industrial production declined only about 1 percent in March, well below the drop in prior months. Nonfarm payroll employment also fell less sharply in March than in previous months. Yes, employment and production are still going down but not as much as a few months ago.

And, more important than that, we begin to see favorable signs pointing to recovery. Retail spending except for autos has picked up a little. Inventories have been slashed to a point where businessmen in some lines have begun to increase their orders. The rise in stock prices is a good sign. And the inflation rate, though still higher than we would like, has come down from around 14 percent to 8 percent. I do not believe that these pieces of evidence represent merely signs of spring. Rather, they indicate that the economy is close to bottoming out.

I recognize that to some of you such a statement may sound optimistic, since there is still such a mixture of good and bad news. Yet crosscurrents of this sort are typical of the late stages of recessionary periods. Therefore, the current recession, in my opinion, will be over before you know it. I won't be so bold to predict four in the afternoon of June 15 is going to be the time and day this will happen. And I certainly don't expect the unemployment rate to come down quickly. But I would be surprised if the turning point of the recession did not come in mid-June, give or take a month.

So much for the past and the immediate future. Where do we go from here? A lot depends on confidence. What kind of confidence will the consumer express? The consumer--and this group, of course, includes you and me--has been in a state of shock for a long time. He has been troubled by inflation eroding his buying power and the value of his savings. And, as recession set in, unemployment became a further source of worry.

How has the consumer reacted to all this? The answer is: He has pulled in his horns, cut down his spending, and prepared for the rainy day. Statistically, the personal saving rate has climbed to around 8 percent.

The question important to us now is: What will the consumer do with the tax rebates and the extra money in his paycheck when the withholding schedules are reduced? Will he rush to buy a new car or some other big-ticket item the manufacturers would love him to do? My guess is that he'll do nothing of the sort. The tax reduction, while large in total, does not amount to much per family. The maximum rebate check will be $200. Therefore, I do not expect the average person to go on a spending spree. Chances are that he'll use most of his tax savings to pay back debt and put the rest in his bank or thrift institution account. For the economy, this wouldn't be all that bad. Banks and thrift institutions lend their money out so that this money will ultimately find its way into the spending stream.

The only part of the recent tax legislation that might have a large impact on major purchases is the tax credit people get for buying a new home. This credit, amounting to as much as $2,000, is just what the troubled building industry is looking for to move the many houses now on the market. The other major factor encouraging the housing industry is the fact that the thrift institutions, which account for most of the home financing, are experiencing an enormous deposit inflow. With credit easier to get and both mortgage rates and building materials costs down a little, we therefore see at long last a ray of sunshine in the housing situation.

I mentioned earlier how important consumer confidence is to the economic outlook. Business confidence, in my opinion, is an equally critical factor. How will the businessmen react? Will he be discouraged by the drop in his sales? Will he, therefore, pull in his horns, postponing plans for future expansion and for buying new modern equipment? Will he, in other words, look optimistically to the future or will he be a prisoner of the recessionary past? I would imagine that his confidence cannot be too high right now. Consumer attitudes, after all, still seem depressed according to all the surveys I have seen. And I don't have to tell many of you that the average businessman's sales generally are still low. Quite possibly, he is still in an over-inventoried position; and, considering the production cutbacks he has had to make, he can surely fill his incoming orders handily with his present capacity. That's the way, according to many reports we receive, the average manufacturer seems to be thinking and reacting. And the effect of it is that he is scaling back on previous modernization and expansion plans.

What are the chances of this attitude changing before long? I think it eventually will. When his sales pick up and economic activity in general recovers, he'll become more optimistic.

Meanwhile, he has already received one important incentive to go ahead with his investment plans and do what's necessary to get himself into a position to meet future sales prospects. This incentive is the investment tax credit the Congress recently enacted. It helps encourage him to take advantage of less costly, more efficient production methods, which is one of our best hopes for defeating inflation in the long run.

I have talked about consumer confidence and talked about business confidence. What about confidence in Government? This question is not related to Watergate or morals. Rather, it addresses itself to our fiscal problems, spending, and the size of the Federal deficit.

I should like to dwell on this subject for a few minutes because how it is ultimately answered may have a lot to do with the outlook for the economy. As you know, the $24.8-billion tax cut law was larger than the President had wanted and more than, in my opinion, is necessary for stimulating the economy. President Ford in early February had recommended a $16-billion tax cut, recognizing that this would add to an already large Federal deficit. He then noted that the drop in revenues caused by tax cuts and personal income and corporate profit reductions would deepen the Federal deficit to $52 billion for the fiscal year beginning July 1, even without new spending initiatives.

One would think that a deficit of this size could provide all the stimulus the economy is likely to need. But here we are, less than three months later, and the Secretary of the Treasury tells us that the fiscal '75 deficit could amount to $70 billion; while the President, in signing the tax cut bill, warned that he could see a deficit of $100 billion.

I shall return to the matter of the size of the deficit. But let me point out that at the heart of our fiscal problem is not merely the existence of a large deficit as such but the tendency for Federal spending to grow at jet-like speed. I am concerned that some of this extra spending is more than is necessary for helping turn the economy around. Certainly, we need to act to stimulate the economy. But let's do it with dignity, not harm. The tax cut and spending surge under way is already enormous, and the recovery is just around the corner. Therefore, no additional Federal spending seems necessary for getting us out of this recession.

What I fear is a policy of overkill or overexpansion, in which case the economy, moving from peak to valley, may resemble a roller coaster. With the end of the recession nearing, I hope most of all that we not overreact and not get so overexcited about the unemployment situation and other economic problems that we make so many moves which in the long run haunt us. Perhaps, some of these actions, such as a public works program, may help us now. But it takes time to put such a program into place. What about 12 or 18 months from now? Would it help us then or would it hurt us? That, it would seem, should be an important test by which we should consider the value of these proposals.

When we made mistakes in the past, it has often been because we overreacted, pulling out all stops, to problems that were either temporary or, where otherwise, we would have been better off to have done less and allowed things to work themselves out. At other times, we acted to fight the symptoms instead of the disease and, in the process, hurt rather than helped the patient.

One of the best examples occurred only a short time ago. Following many and largely unsuccessful attempts to defeat the tide of inflation, we resorted to price controls in 1971. Then, all of a sudden, the inflation slowed down dramatically. We congratulated ourselves and, even many previously skeptical of price controls, wondered if price controls might not be the panacea after all. But then, all of a sudden, the inflationary fever broke out worse than ever. What had been overlooked was that price controls interfere with the laws of supply and demand. As businessmen were not allowed to increase prices, or only slightly, they found it unprofitable to produce certain goods. With supply shrinking, on the one hand, and demand expanding, on the other, the dam was broken. Rapidly rising prices made a shambles of the controls program; it was later abandoned altogether but not before inflation surpassed rates not experienced in several decades.

What does this experience have to do with Federal deficits and other problems of today? Namely this: Price controls bear some blame for the inflation, as we resorted to the wrong kind of economic medicine.

Now everyone is getting into the act, telling us what should be done, prescribing one kind of economic medicine or another. At the risk of repetition, this country, in my opinion, doesn't need any more fiscal stimulus. Being basically optimistic and conservative, I think we have taken all of the necessary fiscal steps in planning the upcoming recovery in the economy. The President has asked for action. The Congress has responded; more than necessary. The Federal Reserve, in stimulating money and credit growth, has been doing its part toward ending this recession as well. The private economy has made adjustments and, as noted before, every one of these developments is beginning to bear fruit. Therefore, I ask: Why not put a halt to more fiscal stimulus and hold the line against new spending programs no matter how lofty their social purpose? Let us keep in mind that there is a tendency for Government spending programs to continue and expand when they are no longer needed.

In financing these growing expenditures, we are now faced with the big job of meeting a deficit that threatens to require the biggest yearly borrowing since the second World War.

A big question facing the credit markets is whether this deficit can be accommodated without cutting out the needs of private borrowers. With the taxing power the U. S. Treasury has, we know the Treasury will get its money. But what about the private sector of the economy?

When the economy is weak and private credit demands are low, it may be possible to meet everybody's credit needs, private as well as public. But what if Federal borrowings go through the roof and private borrowers also require vast sums? Then, as credit demands exceed supply, we have been warned that interest rates might rise and some private borrowers might be crowded out, finding it unable to get the credit they want. This might result in less spending-push the economy needs for a sustained rise in economic activity.

Such a scenario of rising interest rates and crowding out of various private borrowers is not one I necessarily predict. But it is one that could happen if extremely large Federal and even modest private credit demands come together.

The only way such a development can be avoided is for the Federal Reserve to act in ways that would meet the enormously enlarged credit needs. Many would consider this course of action by the Federal Reserve highly irresponsible because it might unleash a violent inflationary spiral--perhaps not immediately but almost certainly in due time.

Therefore, I urge you to heed the President's warning and to help him hold the line on the Federal deficit. If this is not done and the Federal Government were to get rampant in its financing, the nation could face very difficult times. What would be the attitude of private individuals to a $100-billion Federal deficit? Would they react by borrowing more heavily, looking to pay back in cheaper dollars? This psychology by individuals might, in turn, be transmitted to corporations which could spell real trouble. Mind you, I am not predicting this course of events. But it is a possibility if we don't watch out.

Thus, much depends on the President's determination to hold the line on spending. To be realistic, this may be tough to accomplish. We can, therefore, anticipate difficult choices and difficult decisions.

I think it is up to all of us and you leaders in business and the community to be aware of these difficulties that lie ahead. We must use our influences to see that the decisions are the best man can devise, and not just for the sake of today but for the days to come.